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SOME PRACTICAL ASPECTS

OF

C O O P E R A T I V E S

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UNITED STATES DEPARTMENT OF AGRICULTURE
FARM SECURITY ADMINISTRATION
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To: All Regional Directors

Subject: Some Practical Aspects of Cooperatives

The attached booklet represents a contribution by Malvin L. Ross, a member of the staff in the Cooperative Division. ~~It is not to~~ be considered as an FSA Instruction or as affecting in any way existing FSA procedure. This booklet is intended for use as educational reading material, since it treats of practical problems encountered in the organization and operation of cooperatives. It should be particularly valuable to FSA borrower associations whose members usually have had little or no previous experience with the business aspects of cooperative associations.

The writer prepared this booklet in connection with some educational work he was doing, and it contains some valuable information in the field of cooperative finance, management, and accounting.

If you feel that this booklet should be placed in the hands of District and County RR Supervisors as a handy guide or reference material to supplement the Supervisors' Guide for Community and Cooperative Services, it is suggested that each Regional Office submit a request for an additional supply to the Cooperative Division in the Central Office.

Sincerely yours,

Karl J. Magleby

Karl J. Magleby
Assistant Director
Cooperative Division

Attachment

D E D I C A T I O N

To those individuals who have recently become imbued with the cooperative vision and are now traveling the hard road toward the practical achievement of that ideal . . . .

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F O R E W O R D

The fascinating story of cooperatives has been expounded in many volumes, volumes that recount the tale of the struggle of the Rochdale pioneers to become established and that trace the growth of the movement in all parts of the world. Most of these discussions are concerned with a rendering either of the history or the philosophy of the movement. Few answer the practical problems that cooperatives are certain to encounter. Problems such as what type of capital structure should be set up, how can more capital be raised, credit policies and distribution of dividends.

It should be remembered that a cooperative is a form of business enterprise and consequently must observe all the principles that guide such organizations. But the cooperative is more than a business. If run properly, it offers to its members the opportunity of democratic control. Every member is entitled to an equal voice in the management of his cooperative regardless of the extent of his financial interest. Further, the cooperative may offer a service to the community that a private business would disdain to perform because it was not profitable.

Unless democratic control, altruistic service, and other guiding principles of cooperatives are observed, it would seem unnecessary to establish a cooperative. It is much simpler to organize a private business and to start it functioning than to coordinate the thinking of 10 to 200 individuals or more and get them to agree on a plan of action.

In the pages that follow, the writer has taken the financial or practical viewpoint in the various discussions. There has been an attempt, however, to temper the material viewpoint with cooperative philosophy.

SECTION I

SPECIAL APPLICATION OF FINANCIAL STATEMENTS TO COOPERATIVES . .

Management

In a paper of this type, it should not be necessary to delve deeply into the practical value of financial statements. Much of such information has been expounded fully in many standard texts or manuals on financial organization and management and it is desired here to present only facts and, sometimes, views that have been acquired through an intensive survey in the field of cooperatives. Whenever a statement is presented in this thesis that one might argue could be found in some published text, the writer will plead guilty on the grounds of necessity. That is, necessity, because of the desire to stress some particular relationship or to emphasize a fact.

Financial statements are a "must" in any well organized business of any size whatsoever. The larger the organization, the greater the need for more elaborate and more detailed statements. Closely aligned with this "must" is a second, and just as important a "must" - adequately trained individuals who can interpret these statements. Of course, it is obvious that proper records must be kept in order to form a basis for these financial statements.

Most business today is out of the hands of the personally controlled organization with the owner familiar with the most minute details of all phases of operation. The trend today is toward specialization and concentration, and the capable executive must be able to manage and guide his organization through the medium of reports.

Cooperatives are largely in this type of management class. While many of the cooperatives start out in a small way, and usually never grow to any extent, they may expand and become a very definite factor to be considered in the competitive field if they are well managed and supported by their members. Since the management is never the entire owner, financial statements have the same importance in a cooperative that they have in a corporation. The management is, in a measure, fulfilling a trust, a responsibility placed in their hands that they must administer as faithfully as though they were handling their own wealth.

The two factors most responsible for a cooperative's success or failure are management and patronage. Since cooperatives are relatively a new field in America and since many of the people who organize them have little or no knowledge of business practices, the mortality rate in the movement has been high. Cooperatives, to succeed, must follow all the precepts of good business management. Merely to have the general support and approval of the community is not sufficient. Poor management can run the best organized and supported cooperative into the ground within a few years.

That is why a management must be obtained that understands the value of financial reports and can intelligently interpret them to the best advantage. With reports it can check the resultof the practices that it has been following during the previous period and make necessary readjustments for the ensuing period. Has there been an extension of too much credit? Is the inventory getting out of hand? Is the association still undercapitalized? Is it advisable to recommend the declaration of a dividend at this time? Are expenses being kept in line?

How does the profit percentages compare with previous periods and with concerns engaged in the same line of activity? How do operations compare to the budget established for the period? The answers to all these questions and many similar ones must be obtained by the management if it is to function properly. A management without proper financial statements or the ability to adequately interpret those statements may be compared to a blind man faltering down a strange street beset with many pitfalls.

Investors or shareholders

There is a strong distinction between an investor or shareholder in a cooperative and the same type of individual in a corporation. The majority of investors in corporations are interested principally in returns and profits. They have purchased stocks or bonds in that corporation solely because they believed that such were good investments, and, as long as the corporation's profits were earned in the popular legitimate sense, gave no further thought to the practices that the corporation may have followed in order to achieve that aim.

An investor and particularly a shareholder in a cooperative is imbued with an entirely different objective. There are several basic distinctions between this individual and his contemporary in the corporation. He does more than

just invest in the cooperative, he also deals with it in a business sense; he is a patron; and he expects that organization to render him some material service. He is curious as to just how that cooperative is functioning because to him cooperatives are more than just a means of business, they are a way of living.

There is no limitation placed on ownership of shares in a cooperative except that a member can not own more than a certain percentage of the total, usually not more than 10%. This limitation is superfluous because few individuals with a profit motive put money in a cooperative as investment. Interest on shares is limited to some nominal amount, ranging from 5 to 8%, and no matter how many shares are owned by a single individual, he is allowed only one vote. The shares are purchased without any speculative intent because the association will offer to buy back any share at par or will sell shares at par. The cooperative follows the principle of open membership and will sell shares to any individual that meets its membership requirements. A so-called "closed corporation" could never exist in a true cooperative.

For those reasons the member should take an active interest in the affairs of a good cooperative. After all, it is handling his produce or merchandise and his livelihood or success as an individual may depend entirely on its successful operation. In order to follow the cooperative's financial affairs intimately, it is necessary for him to be able to read and interpret correctly the cooperative's financial statements.

Cooperative members are hampered in this respect because many of them lack the required training to correctly interpret these statements. But they must master this knowledge if they are to effectively control and exercise sound judgment relative to the cooperative's operations. Toward this end, cooperatives annually set aside a portion of their earnings in an "educational fund". Now of course, all of that fund is not used to just train the members to read financial statements. A good portion of it is used to attract new members, train current members in cooperative principles and their application etc. However some of the fund is applied toward training the members to analyze their statements in order that they may become better members.

As an educational device, some cooperatives have also attempted to simplify the conventional statement form

to make it more readily understandable by the average member. In the appendix is included a type of simplified statement that has been designed with this end in view. Your attention is called to the absence of technical accounting terms and the substitution of common explanatory phrases. It is thought that these simple statements could be distributed for the members' information but that the technical and more detailed statement would be made up for the information of the management and other interested parties.

Government - tax purposes

Cooperatives enjoy an enviable position under the federal income tax law, capital stock tax law and under similar laws in the various states in which they are organized or operate. The federal government as well as the state governments have recognized the practical value of cooperatives and their principles and have generally ruled that associations operating under such principles are exempt from various types of taxation. In this manner, the federal government and the various state governments have encouraged the further growth of this type of organization.

The basis for this ruling in most cases is that the cooperative is organized on a non-profit basis.

In order to obtain the various tax exemptions, the cooperative must apply to the Collector of Internal Revenue who will adjudicate the individual case. The basis for determining exemption consists of an examination of the association's Articles of Incorporation, By-laws and also its financial statements. The financial statements are examined to learn the disposition of the association's earnings. If the earnings represented a sizeable amount of the capital investment and were transferred in toto to a reserve account without crediting the members' or patrons' account with a proportionate share of the earnings, the decision is likely to be adverse. The federal government does not disapprove of reserves, but it stands on the ground that if the association is organized on a non-profit basis, the profits or excess earnings must be either distributed to the members or credited to their accounts. The state taxing authorities will generally follow the federal governments decision in the case.

Needless to say, after the Collector of Internal Revenue has rendered a favorable decision, he has the peroga-

tive to examine subsequent statements of the cooperative in order to make sure that they are still complying with the requirements of their exemption.

Creditors

Creditors of a cooperative do not differ to any degree from the creditors of a corporation or any other form of business. They are usually divided into two classes, namely short term creditors and long term creditors.

Short term creditors consist generally of other businesses that sell their merchandise on credit. Cooperatives strive to eliminate this type of creditor by buying for cash and thereby also taking advantage of cash discounts. The short term creditor would want a statement from the cooperative to ascertain its current position - he is interested in determining its possibilities of paying for the merchandise in as short a period as possible.

Long term creditors generally loan money for the purchase of fixed assets or working capital and in turn will take a mortgate on as much of the fixed assets as they can. Since cooperatives try to remain in as liquid a position as possible, they would naturally seek to avoid incurring any fixed debt or would try to liquidate any fixed debt as soon as their earnings would permit.

Long term creditors, who also might, in a sense be termed investors would want to know all the pertinent facts relative to the cooperative that could only be furnished by a financial statement.

SECTION II

CAPITAL STRUCTURE OF COOPERATIVES

Equities

The term "Equities" as used in cooperative accounting will generally signify the same thing that Net Worth signifies in corporate accounting. An attempt is made in using the term "Equity" to get away from the accumulated profit idea suggested in the term "Net Worth" and to stress the cooperative factors. Emphasis is placed on the sharing of the assets of the association in a more equitable fashion.

The caption "Undistributed Earnings", "Additional Members' Equities" or "Patrons' Equity Reserves" would aptly substitute for the expression "Surplus". Here too, the corporation profit concept is revised and cooperative principles inserted. Secondly, it is more adviseable to use some other term than "Surplus" when consideration is given to taxation. A cooperative should distribute its savings in a cooperative manner, and hence when a surplus is shown, it is necessary to prove that the patrons have been allocated an equitable share of that surplus. A more descriptive title would partially alleviate that problem.

Should the association set up a reserve account out of surplus, continuing along in the same cooperative trend, it could be titled "General Reserves". Under this caption would appear Savings Retained from Prior Years and the Current Year's Savings.

One of the first things striking a person who is studying cooperative statements for the first time is the elimination of the expression common & preferred stock and the substitution of common & preferred shares. Thus the thought connotation of owning stock for profit is removed. Shares brings forth the idea of greater equity - one share, one vote. The word Cooperative derived from the Scandinavian language literally means "share activity".

Shares - common and preferred

The established concept of corporate structure holds true for cooperatives to a great extent. The current practice for the majority of cooperatives is to base the capitalization of the organization on either common shares alone or in a combination with preferred shares.

If the shares are exclusively of one class, i.e., common, they are usually of a high par value, ranging from $50 to $100 and in some instances even higher. There are disadvantages to this type of capitalization: The high par value of the share necessarily limits ownership to those individuals who can afford to lay out a large sum of money at one time. This would eliminate a number of potential shareholders who perhaps use the services of the cooperative and are entitled to join, but are forced to remain as non-member patrons.

In the writer's opinion one of the better methods of capitalization would conform to the following plan: The par value of the common share is set at some low nominal value, preferably at the $5.00 level. Any amount less than that does not give the shareholder a definite feeling of having made a financial investment in the company. He is, therefore, not likely to have the same feeling of responsibility in the cooperative's welfare as he would, were he to invest a more sizeable sum. The reader must realize, however, that any amount is to be tempered according to the income level of the people the cooperative is to serve. Cooperatives as a rule deal with the low or middle income groups and consequently, it is believed that $5.00 would be the proper amount to set the par value of the common share.

No cooperative could properly be financed on merely this small investment in common shares. The writer says small investment in common shares, because he would limit the sale of common shares to only one per patron. No person who was not a patron would be permitted to purchase a common share. The management of the cooperative would rest solely in the hands of the people it was to serve and a safeguard would thus be established to ensure that the cooperative would function for the greatest benefit of the patrons and not just the shareholders.

Raising additional capital would be a major problem of a cooperative organized in this fashion. For this purpose, the writer would lean heavily on the sale of non-cumulative

shares. The interest rate on this class of shares would be set at some low value, certainly not more than 6% and preferably at even a lower rate. The rate is usually limited by State law. The par value of this share would range from $1.00 to $50. This class of stock should be sold to all interested individuals, whether or not they are patrons. No limit should be placed on any individual's holding, but care should be taken that the state law is not violated, because some state's cooperative laws forbid any single holding of more than 10% of the outstanding shares.

The share retains mentioned in the following section could also be applied toward the purchase of preferred shares.

Considerable emphasis has been placed on the thought that preferred shares should be of a low par value. In this manner the amount of patronage retains in each patron's account would reach the value of a preferred share more rapidly. The patron then could receive something more tangible for his contribution than merely a bookkeeping entry.

Should the sale of shares prove to raise an insufficient amount of capital, there are various government lending agencies established to aid the cooperative. The two leading agencies are namely, the Farm Credit Administration and the Farm Security Administration. There will be no attempt made to explain their loan requirements here, as that would be out of the sphere of this paper.

Retains for share purchase

Cooperatives having shares of high par value have adopted the device of stock retains to enable non-member patrons who are not able to purchase a share to acquire ownership on an installment plan. This method of share retains takes two forms:

1. Patronage dividends declared payable to patrons on their past year's business are credited to this account, if the patron is not already a member. The dividends accumulate annually until such time as they are equal to one share, at which time, the patron will receive the title to the share and his patronage credit account will be closed.

Some associations however, do not wish to carry patronage credit accounts an indefinite period for the patron. Their By-laws stipulate therefore, that if after a certain period,

usually not more than five years, the patron does not supply sufficient additional capital to enable the association to issue at least one share, the patron's balance in the account after that period will be closed out. The patron will lose the benefit of those retained dividends and they will be credited to an educational fund or a general reserve.

2. The other method of share retains is to assess the patron a nominal extra charge per certain unit volume of sales. Thus if the cooperative in question were a grain elevator, the patron would be charged 2¢ extra per bushel handling charge. Of course, the patron should be made to fully understand that this deduction is not an extra expense, but is in reality a capital contribution based on his ability to pay.

This system of retains should not be construed to apply solely to associations having shares of high par value. It is a suitable device for any cooperative to effect when it is in need of raising additional capital. As it will be shown under the revolving capital plan, it is an excellent means by which fresh capital can be continually introduced into the association.

Shares - Revolving

A successful co-op must be controlled by its current active patron-members. Co-ops in the past have been organized along traditional corporate lines of common and sometimes preferred shares thus ignoring the above basic rule. For as time went on, many of the original members became inactive, but retained their membership in the association because it was profitable investment. The co-op's policies then became dictated by these inactive members and many times the policies were decided on the basis of greatest return on their investment rather than on the basis of giving the best service to the patrons. A situation of this type does not tend to keep a cooperative in a healthy condition and in time it may possess all the evils that it was organized to combat.

A major difficulty of many cooperatives is inadequate capital. Many of the co-ops are organized on the veritable "shoe string" and if they are to survive, they must raise additional capital by the sale of shares, which is oftentimes a difficult task in a poor community. An alternative to that is the retention of all excess savings;

that is, all earnings over those allocated to necessary reserves.

Another means of raising additional capital is through the medium of patron retains, heretofore mentioned, assessed in each dollar's sales.

Periodically, either semi-annually or annually, the association will issue to the patron one of the following to indicate his current capital contribution:

1. Certificate of Indebtedness - without due date
2. Common or preferred shares
3. No tangible evidence, but merely a bookkeeping entry

Following the above mentioned procedure it can be thus seen that capital can be accumulated through either a restriction in the declaration of cash dividends or by collecting retains. After a certain period of time has elapsed, the capital requirements of the organization may be satisfied and it should be satisfactory to declare a cash dividend. This dividend is used to pay off the oldest outstanding claims of the members. It is precisely at this time that the revolving capital plan comes into action. For it can be seen that if the oldest capital contributions will be retired, this will automatically eliminate the capital contributions of those members who have ceased to patronize the co-op, and just leave in the cooperative the capital of the members who are actively engaged in using its services.

There is some question in my mind whether or not this revolving capital plan should also eliminate the common shareholders. In an organization where the cost of a common share is very nominal, say $1.00 to $10, there might be some doubt expressed as to whether that share should be retired. If the co-op is organized properly, a definite limitation would be placed on the amount of interest payable on that share as dividends and all excess savings would be declared as patronage dividends.

It can, therefore, be seen that the share would not be held because it was a profitable investment, but merely because the shareholder still wanted to maintain some interest in the cooperative. Perhaps he was one of the original incorporators and though it was impossible for him to deal with the co-op any further, he did not want to give up all connections with it. The counsel of these older members who may have been

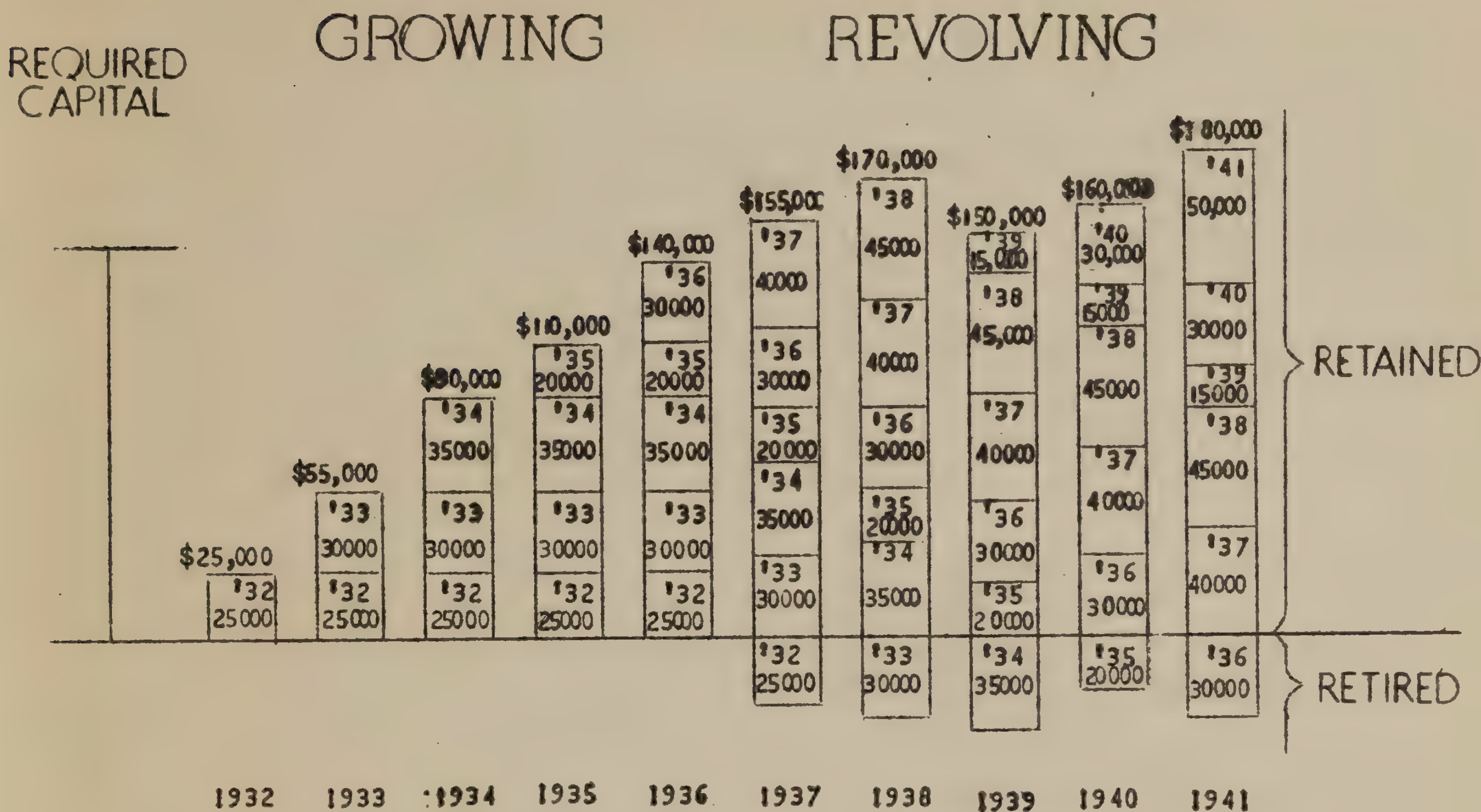
constantly encountering and solving the past problems of the co-op might prove to be of inestimable value in present and future operations.

A provision should be made in the revolving capital plan whereby all other shares or forms of capital contribution might be retired, but the common stock would remain in force.

Should this procedure be followed and the association had common shares of a low par value outstanding in the hands of inactive members, they could always retire their investment by resale back to the co-op. The co-op should always make some provision for the retirement of any common shares that the members desire to liquidate.

If the common share has a high par value, then it would be advisable to retire that also under the revolving capital plan.

CAPITAL OF A FARMERS COOPERATIVE



"This chart illustrates the operation of the revolving capital plan. In the illustration chosen it takes 5 years for the capital to start rotating. Each one of the blocks represents 1 year's deductions. It will be observed that in 1937 the association was able to retire the initial capital paid in during 1932. In 1938 the association retired the stock issued as evidence of retains in 1933, and so on through the years. It will be noted that the squares for different years are of different size, indicating the fluctuating volume of the several crop years."

"Organizing A Farmers' Cooperative" - S. D. Sanders,
Farm Credit Administration p. 8.

Membership Certificates

Some cooperatives prefer not to issue any capital shares, but instead sell membership certificates. In most instances, these certificates are non-transferable except with the consent of the association and generally are not redeemable. They offer the owner the same privileges that would ordinarily accrue to a common stockholder, with the exception of the above-mentioned provisions. They range in price from 50¢ to $100, the value usually being set at the income level of the patrons.

Certificate of Indebtedness

Certificates of indebtedness are closely aligned with the peculiarities of cooperatives, but oftentimes are used in corporations under a different title.

Cooperatives, as stated before, generally have capitalization troubles. As mentioned under "Retains", conservative cooperatives will not declare cash dividends when they are trying to build up their capital structure. When a period's operations are sufficiently successful to warrant declaring a dividend, the patrons and shareholders might be issued in lieu of cash, certificates of indebtedness to indicate their interest in the association's earnings.

It should be noted that patrons were included along with shareholders as receiving those certificates of indebtedness. If a cooperative is to comply with the federal income tax law, it must distribute dividends to all patrons, even if they are not shareholders.

The certificates of indebtedness will be of two types:

1. Without due date -

   If the association is indefinite as to when it will be able to redeem these certificates, its wisest policy would be to declare the certificates and not set any particular date on which they would be redeemed. In such instances, the certificates would not be considered a liability of the association, but should be carried in the equity section of the balance sheet and considered to be of lesser liquidating value than any share issue.

2. With due date -

Associations that issue certificates of this type are fairly certain that they will be able to redeem them at some contemplated future date. These certificates represent actual liabilities of the association and should be carried on the balance sheet in that category, their exact position being determined by the proximity of the period in which they are falling due.

These certificates are also issued not because of a dividend declaration, but as evidence of the association's indebtedness to a creditor. Certificates sold in this fashion should be regarded as though they were term notes payable, and generally they would not draw interest.

SECTION III

CREDIT POLICY . .

Cash basis

One of the fundamental tenets of the coöperative philosophy has been the attempt to operate on a strict cash basis. Now it is true that many students of finance and economics will bring up countless arguments and point out thousands of examples of how and why credit is absolutely essential in our modern system of commerce. One cannot help but agree with many of their arguments but the irrefutable proof of the opposite contention is the fact that many of the present day cooperatives extend little or no credit to their patrons.

In the initial period of the cooperatives it is usually necessary for them to obtain a loan from some financial source in order to be able to purchase facilities. Coöperative philosophy does not disagree with this practice, but it demands that this loan be paid off as speedily as possible. A transaction of this type can be considered to be of an extraordinary nature and not encountered in the daily course of operations.

The daily operations of buying and selling of the ordinary trading cooperative should rest mainly on cash transactions. It is not necessary that the cooperative pay spot cash for its purchases unless it can derive a greater financial discount for so doing. Otherwise it would be just as prudent to follow the usual credit terms of the trade.

On the other side of the operations, namely, selling, the same principle should be observed. All sales to patrons should be made for cash only. One of the greatest causes of failure in cooperative ventures is the injudicious extension of credit to patrons. As stated before, cooperatives deal with the middle or low income groups and while no attempt is being made on the writer's part to cast aspersions on their integrity, credit is often granted to them in such volume that it becomes practically impossible for them to repay the account.

As might be expected there are a number of modifications to such a drastic policy. Cooperatives adopt them, complaining that competition forces them to it. This is not quite

true. A good number of retail and wholesale organizations are established on a cash principle and in almost every line of endeavor. Added to this argument is the thought that if the patrons had been sufficiently educated the "cōop way", their demands for credit would cease.

Credit up to amount of patron's interest in Co-op

This is a device which some cooperatives use as a means of granting credit to patrons and yet is an excellent check toward that bugaboo of most cooperatives — over-extension of credit. A goodly percentage of the cooperative's patrons are shareholders or have made a partial payment toward a share of stock. In some instances this partial payment may have been made because of a patronage refund earned in a previous period. Most shareholders, too, will have had patronage credits in their accounts that had been declared but not distributed because of the cooperative's desire to build up its capital. In this method then, the patrons are allowed a purchase credit up to the amount of their investment in the cooperative. Thus, while the liquidity of the accounts is not assured, the cooperative does have the assurance that it will not suffer any loss due to credit extension. If all means of collection fail, the patron can be asked to forfeit his stock, or his patronage credit can be cancelled out against his outstanding indebtedness.

Manager's reserve

A few cooperatives put the responsibility for the credit policy squarely on the shoulders of the manager. He is informed that the association should operate solely on a cash basis and if any credit is extended, he will be financially liable if collections are not made. To establish a definite financial liability, the cooperative deducts a certain percentage of the manager's salary and commission and sets it aside in a reserve similar to a reserve for bad debts. For example, one cooperative at Elgin, N. D. operating a service station, had accounts receivable in the amount of $2,800 and had established a managers reserve of $1,960. The manager's total salary and commissions that year amounted to $2,000 and out of that sum $600 had been withheld to be set aside in reserve against possible bad debts in the outstanding accounts.

A large deduction as this may appear to be severe against the manager but it serves as an excellent device to

make him cautious in granting credit and will greatly tend to keep the association on a cash basis.

Another useful purpose to which the manager's reserve may be put is in the matter of inventory shrinkage. It should be the manager's responsibility to see that adequate controls are maintained over the stock on hand. Any unreasonable shortages should properly be reimbursed by him. Thus in gasoline, a shrinkage of 2% is allowed in the gross volume. All shrinkages over that amount would be charged against the manager's reserve.

SECTION IV

POOLS . .

One of the most popular of all cooperative activities is to be found in the field of pools. Attempting to describe a pool briefly and taking up each item in more detail later, let us consider a tomato canning plant. The principles applicable to its operations will probably be the same as in any other type of pool activity.

The grower before the season has even started has signed a marketing agreement with the cooperative cannery to deliver a certain number of bushels of tomatoes at harvest time to the cannery.

At harvest time he brings his tomatoes to the cannery and receives a slip which indicates the amount of tomatoes delivered and their grade. If he desires, and most of them do, he can receive a small cash advance from the cannery on his tomatoes to cover harvesting and delivery expenses.

The tomatoes are processed by the cannery, canned and either sold immediately or held for a favorable market. As the canned tomatoes are sold, more advances are made to the grower. The total of all these advances at no one time should exceed a certain percentage of the market value of the raw tomatoes. Following this method, the cooperative will be certain that it is paying less for the tomatoes than their relative value in the finished product.

Finally after all the processed tomatoes have been sold, the expenses of the pool are computed, deducted from the selling price of the tomatoes, certain reserves are set aside for the cooperative, the remainder of the sales proceeds are distributed to the growers and the pool is closed.

The cannery does not possess title to the tomatoes and the grower relinquishes his title to his particular tomatoes and obtains a proportionate interest in the entire lot of tomatoes contributed by all the growers. The entire lot of tomatoes is known as the pool.

This very hurriedly is the operation of the pool. Its most distinguishable features are:

1. All producers products are lumped together in a common pool and each contributor only receives a proportionate share in the whole with possible allowances for differences in grade.

2. The products usually are not sold to the cooperative, but are only handled by it for all the members.

The following will be an elaboration on the operation of the pool--taking up the technical features and attempting to clarify them. An examination of the sample pool operating statements carried in the appendix also might prove of value.

Marketing Agreement

The growers in signing this agreement, contract to deliver a certain amount of their produce to the pool. If the harvest is poor and they fail to meet the quota they have agreed to deliver, the grower is not penalized. If the grower raises and harvests the anticipated crop and then fails to deliver the produce to the cooperative, he is penalized a certain cash amount for every bushel he fails to deliver.

Although most cooperatives have the ability to assess this penalty and enforce its collection through legal means, the majority of them depend upon community censure as a means of collection. If the grower is "thickskinned" and a good number of them are, the coop will fail to collect its penalties.

Unless the cooperative does make a strenuous effort to collect these penalties, it might be the beginning of its downfall. Each year more of its agreements with the members will be violated with impunity if the growers find it more profitable to sell their goods elsewhere. Without a certain volume, the cooperative will be unable to meet its fixed overhead and it will be forced to fold up--lost through the blindness of its uncooperative members and its own weakness in refusing to enforce the marketing agreement. Then the cooperative's competitors having forced its dissolution can charge or pay the prices they choose and the grower will find himself at their mercy.

Advances

The initial advance is made to the grower at the time he delivers his produce to the cooperative. This advance generally covers only the growers' out-of-pocket costs for harvesting and delivering the crop. It should not exceed more than a certain percentage of the market value of the raw product and is often less. Nothing additional is paid to the grower until after the processed product is sold on the market.

As the finished product is being sold, the grower receives additional advances. The cooperative must be careful not to advance to the grower his entire proportionate share of the selling price. A sufficient reserve should be withheld to provide for any future decline in selling price which in normal times often occurs. A sufficient reserve must also be maintained until all expenses of the pool are determined. Final settlement is not made with the growers until the entire inventory is liquidated and all possible expenses of the pool have been taken into account.

For balance sheet purposes, advances to growers is considered a current asset only when such advances have been made prior to any commodity being received by the association for inventory. Such advances would be made for the purpose of purchasing seed, fertilizer etc. At all other times, the advances are closed into the general pool account and are not shown separately on the balance sheet.

Inventories

The question of valuation of inventories in pools is a controversial issue. It might be considered to have no value other than that of the expenses applicable to that pool. The proponents of this idea cite the common practice employed in general accounting to value inventory at cost or market whichever is the lower. But carrying through on this theme leads to absurdity. The important factor in pools is that the association never purchases the major raw product. The inventory would then be vastly understated, if only the actual costs were set up for balance sheet purposes.

It is necessary to determine, therefore, some valuation for the commodity delivered to the pool. In the case of products that are not processed and are sold completely at frequent intervals, the cost of the commodity could be considered as that amount returned to the producers. This

solves the problem rather neatly for that type of product, but what about those commodities that require processing and may be carried on the balance sheet for one or more periods before the pool is closed?

A method that has been adopted by canning associations and by various other types of associations having products requiring long processing periods somewhat violates the established accounting rule for inventories. Under this method, the value of the inventory is computed at the market selling price less selling costs which average about $2\frac{1}{2}\%$ of the market price (See appendix 3 C). Some cooperatives also set up a reserve for possible market fluctuations and deduct it from the inventory value shown on the balance sheet.

Equities in Pools

"In determining how to show the indicated members' equity in unsold commodity in the balance sheet, we must for the moment refer to the current asset section of our balance sheet wherein we find that the unsold commodity has been valued at the market and the estimated selling costs deducted therefrom.

Some cooperatives show the indicated member's equity in unsold commodity in the net worth section; however, there is considerable argument as to the correctness of this procedure.

Members marketing agreements differ widely as to how the distribution of returns is to be made, therefore, in my opinion an iron clad rule cannot be laid down regarding this point and where the amount determined as members' equity in unsold commodity will be shown depends, to a great extent, upon the terms of the marketing agreement.

An examination of a number of marketing agreements leads me to believe that any amount determined as members' equity in unsold commodity at the date of the balance sheet, should be reflected as a current liability for two reasons:

(a) The unsold commodity has been shown in the current asset section of the balance sheet as a liquid asset, which under normal conditions will be sold during the operating cycle of the cooperative.

(b) The marketing agreement usually provides that after operating expenses and a proportionate amount of the general overhead expenses plus authorized reserves have been deducted, the remaining balance shall be distributed to the members. (This will under normal conditions take place in whole or part during the operating cycle of the cooperative).

I don't believe that the members equity in unsold commodity could be construed to fall into the surplus class in the net worth section.

If the marketing agreement should provide that the directors have the power to declare the amount and designate the time of distribution, then it would probably be desirable to designate a separate caption 'Indicated members equity in unsold commodity' and set it right after 'current liabilities' and before 'deferred and long term liabilities'."[1]

The above discussion seems to cover the topic of "Equities" thoroughly and leaves little more to be said. In the writer's personal experience acquired in reviewing a good number of reports of associations operating under a pool basis, it has been found that the majority of these reports indicate that the credit balances of the members in the pool or their equity is carried in a separate section just below the current liability section.

A situation that crops up more often than it should, occurs when the entire inventory of the pool has been liquidated, the pool is closed and it is determined that the pool has a debit instead of a credit balance. The cause of this condition is the result of over-advances to the members. If the association would have had the prudence to only pay out to the members a certain percentage of their proportionate return, they would have avoided this pitfall.

The question of its proper classification on the balance sheet has several solutions. Some associations forseeing this possibility have established reserves for contingencies, which they charge thereby closing out the account. In my opinion, this is not the proper procedure.

[1] Interpretation of Financial Statements - B. T. Dodder - speech 8/18/36 - To Stockholders of Baltimore Bank for Cooperatives.

The reserve for contingencies account has been built up by prior years' allocation from the surplus account. Participants of prior years' pools contributed to the reserve as well as members of the current year's pool. Since the current year's members benefited to the extent of the debit balance in the pool, it does not seem correct to charge the association's reserve.

A more just and equitable plan would be to attempt to collect from each member the amount of his overpayment. If this course is decided upon, then the total of these overadvances can be considered an asset. Whether it can be considered as a current asset would of course depend upon its collection possibilities. Some associations classify it as a current asset after accounts receivable and then deduct a reserve for bad debts carrying out only that portion of the debit balance that is conservatively deemed to be collectible. It can also be placed under its own separate caption near the end of the asset side of the balance sheet.

Other associations realizing the difficulty of liquidating these accounts after the money has once been paid out have passed a rule that proceeds of future pools will be withheld from those members having past overadvances until such time as their proceeds exceed the amount of the overadvance.

Charges and Credits

Accounting for pools can be considered to be handled on the same basis as one would treat items going into the profit and loss account. That is, separate accounts are set up for each of income and expense items. Some associations close these accounts out to the pool account at periodic intervals, but the majority of the associations hold the accounts open until the pool is closed, or at least until such time as all charges and credits except the final balancing entry going to the account have been entered.

Normal charges to the pool account would be all the expense items. Normal credits to the pool account would be the income accounts, such as receipts from the sale of inventory and other miscellaneous receipts pertaining to the pool.

When an association is operating several pools at one time the problem of unallocable expenses always arises. As

this problem however, is not strictly a pool problem but belongs more in the realm of cost accounting, the same procedure that is followed in determining allocation of costs should be observed.

Occasionally expenses are incurred by the association prior to the operation of the pools. These should be handled as a deferred expense and thus shown on the balance sheet. After the pools are started, the expenses should be distributed to the proper pool and handled in the prescribed manner.

SECTION V

PATRONAGE REFUNDS . .

We have said that cooperatives are organized on a non-profit basis. It is difficult to sell goods or services at exact cost because this is not known until the close of the operating period. Associations have therefore established the principle of selling at market price. At the close of the period, the excess earnings available for distribution to the patrons are determined.

If the association operates just one enterprise or engages in just one type of service the problem of distribution is relatively simple. The refunds are declared as a certain percentage of the patron's purchases during the year.

Complexities develop if the association has more than one "department" in operation. For example, practically every grain elevator has a farm and feed supply business connected with it, and many of them also dispense gasoline, petroleum and auto supplies. Thus the affairs of the elevator fall into at least two distinct departments. The Farm Security Administration has promoted a number of farmer cooperatives throughout the United States that carry on numerous activities. As a nucleus the association might have a purchasing and marketing activity. With it might be associated a cotton gin, a warehouse, a medical health program and sundry other activities. This association could conceivably have four or five distinct and separate departments; some operating at a savings, some at a loss and some just breaking even.

Should the association distribute the savings only to the patrons of those departments that came out ahead during the last period or should it distribute equally to all patrons regardless of the department in which they carried on their business?

It might be asked why the cooperative doesn't discontinue operation of the departments that are functioning at a loss. This illustrates one of the general distinctions between a cooperative and a business organized-for-profit. A cooperative is formed for the primary purpose of serving its patrons in the most efficient manner possible and if there are some services that are considered essential in the community but which cannot be operated except on a loss, the

cooperative will still continue to operate those departments in so far as it can. The cooperative , however, should carefully analyze those department's operations and correct their defects in an endeavor to put the departments on a paying basis.

Inasmuch as the cooperative is operating that department at a loss the other departments would have to maintain it. Following that thought a second question would arise. Does it seem equitable to further support it by declaring a patronage dividend payable to the patrons of that department?

This seems to be a just contention and one that is worthy of consideration. The writer hesitates to put himself out on a limb on this debatable subject, but if pressed, would be inclined to favor the idea of paying patronage dividends to patrons of only those departments that have excess savings. Payment of dividends would be restricted to the extent of the net income of the entire association. In other words, the excess earnings of the individual departments should be held back in a sufficient amount to cover any deficit that might exist in some departments of the cooperative. This only sounds like common sense and I'm sure that no controversy will arise on that point.

Against the above conclusion, however, many cooperative organizations erroneously do not publish detailed statements of operation broken down by departments. If the various departments' earnings exceeded the other departments' losses, this information would not be disclosed on the consolidated statement. Only the net balance or savings would be shown. In this situation the association is free to declare a general patronage dividend payable to all patrons.

The question of patronage refunds is one of the most controversial issues in the cooperative movement and in the above brief discussion, the writer did little more than high light some of the more important points.

SECTION VI

RETAINS - DEBT REPAYMENT

A great many loans have been made and are being made to cooperative organizations as well as to other types of business enterprises which provide for a fixed amount of principal repayment each year. Against this type of fixed principal repayment, another and a more realistic form of repayment, has been devised.

This form calls for a schedule of repayments based on the ability of the association to repay. The association's "ability" is determined usually by its gross income for the period. A certain minimum annual payment is established which the association must meet no matter what its income may be for the period. If the gross income exceeds a certain figure, however, a portion of the income beyond that amount must also be applied toward the debt retirement.

Repayments might also be based on some figure other than a percentage of gross income. It might rest on gross volume. If based on volume the rate of payment would be established as so many cents or fractions of a cent per unit handled by the association. For example, a creamery might have to pay a fraction of a cent for every pound of butterfat handled, an elevator would pay a cent or so for every bushel of grain handled, or so many dollars for every carload shipped.

This method of providing for repayment is commonly referred to as a "retain" - that is an amount is set aside or retained out of every unit or dollar handled by the association. It is very similar to the retain previously discussed but differs, of course in the basic application - namely the former was used for capital building purposes, while this type is used for debt retirement. Some advocates of this method call it the most equitable form of repayment, because the amount is based on the association's earning capacity.

An inequitable situation arises however, when interest on the debt is considered. If the loan is to run for a period of twenty years, during the first half of the loan period the patrons will be charged a good deal more for interest expense by the association than the patrons during the second half of the loan period. These in turn will be charged more than the

patrons thereafter who will not be assessed any interest charge. A suggestion has been made that the interest paid by the association should be capitalized and then amortized over the life of the fixed asset. In this manner, all of the patrons will be charged through the operating expenses with only their just portion of all the loan retirement.

If the retain plan is to function satisfactorily, scrupulous observance must be maintained by interested parties (the creditors, and management of the cooperative), that the association is setting aside regularly in some designated fund, the agreed retains. If this is not done, the association is very likely to find that when the payment becomes due, it has tied up its cash in inventories, accounts receivable, fixed assets, etc.

For balance sheet purposes, the retain set aside to meet the loan repayment requirements is handled merely as a sinking fund might be handled - not as a current asset but probably in a caption located just below the current asset group.

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Farmer Cooperative Audits - H. V. Lindberg

Organization Structure of Farmers' Elevators - Harold Hedges, 1939, Farm Credit Administration

Interpretation of Financial Statements, Purpose and Scope of Field Examinations and Audits - Address by Bernard T. Dodder of the Baltimore Bank for Cooperatives.

Some question might be raised concerning the brevity of the above bibliography. The major portion of the paper was written in accordance with the writers' conclusions which were attained after a study of the cooperative field. During that time access was had to the confidential cooperative files of both the Farm Credit Administration and the Farm Security Administration; several hundred cooperative financial statements were reviewed; and actual operations of various cooperatives were investigated.

The following financial statements pertaining to cooperatives were developed by the writer and other members of the staff of the Cooperative Division, Farm Security Administration.

Appendix 1.

COOP-ASSOCIATION

Balance Sheet
December 31, 1942

ASSETS

The Asset side of the balance sheet has been omitted because there is no apparent difference between a balance sheet of a cooperative and any other type of business in that respect.

LIABILITIES & EQUITIES

Current Liabilities		
Accounts Payable	$ XX	
Accrued Taxes	XX	
Accrued Interest	XX	
Notes Payable Maturing	XX	
Total Current Liabilities		$ XX
Deferred Income		XX
Patronage Refunds - Prior Years		XX
Certificates of Interest (with due date -maturing)		XX
Deferred Liabilities		
Notes Payable - Not matured	$ XX	
Revolving Fund Contribution (Evidenced by Certificates of Interest with due date)	XX	
Total Deferred Liabilities		XX
Total Liabilities		$ XX
Equities		
Capital or Membership Shares	$ XX	
Common Shares	XX	
Preferred Shares	XX	
Retains for Share Acquisition	XX	
Certificates of Interest (without due date)	XX	
Total Capital or Membership Shares		$ XX
Additional Members Equities	$ XX	
Donations	$ XX	
General Reserve		
Savings - Prior Years	XX	
Savings - Current Year	XX	
Total Additional Members Equities		XX
Total Equities		$ XX
Total Liabilities & Equities		$ XX

COOP-ASSOCIATION

Operating Statement
January 1, 1941 to December 31, 1941

Trading		
Net Sales	$ XX	
Less: Cost of Sales	XX	
Gross Margin on Sales		$ XX
Service Department		
Fees, Rentals & Assessments	$ XX	
Less: Direct Expense	XX	
Gross Income on Services		XX
Gross Income		$ XX
Administrative & General Expense		XX
Net Operating Income or Loss		$ XX
Add: Non-operating Income		
Purchase Discounts	$ XX	
Gain on Sale of Fixed Assets	XX	
Total Non-operating Income		XX
		$ XX
Less: Non-operating Expense		
Interest	$ XX	
Bad Debts	XX	
Loss on Sale of Fixed Assets etc.	XX	
Total Non-operating Expense		XX
Net Savings (to Balance Sheet)		$ XX

(Note: Schedules should support all items when necessary.)

POOL SUMMARY

	Total for Month	Distribution to Closed Pools	Balance Open Pools
Sales	$ XX	$ XX	$ XX
Expenses: (Sch. C-1)			
Processing	XX	XX	XX
Selling	XX	XX	XX
Administrative	XX	XX	XX
Total Expenses	$ XX	$ XX	$ XX
Patrons Proceeds	$ XX	$ XX	$ XX
Deductions:			
Advances	$ XX	$ XX	$ XX
Reserves	XX	XX	XX
Other	XX	XX	XX
Total Deductions	$ XX	$ XX	$ XX
Excess Income over Charges	$ XX	$ XX	$ XX
*Add: Inventory (Sch. C-2)	XX	XX	XX
* Patrons Equity	$ XX	$ XX	$ XX

*Carried to Balance Sheet.

To be used only when association has more than one pool.

Appendix 3 B. Pool No. ________

POOL OPERATING STATEMENT

Schedule C-1

Name of Commodity ________

Items			
Income from Sales			$ XX
Processing Expense			
Labor	$ XX		
Containers	XX		
Utilities	XX		
Insurance	XX		
Depreciation	XX		
Repair & Maintenance	XX		
Other	XX		
Total Processing:		$ XX	
Selling Expense			
Salaries	$ XX		
Brokerage & Selling	XX		
Grading	XX		
Labels	XX		
Labor allowance	XX		
Advertising	XX		
Samples	XX		
Discount Allowance	XX		
Delivery Expense	XX		
Other	XX		
Total Selling:		XX	
Administrative Expense			
Salaries	$ XX		
Communications	XX		
Directors' fees	XX		
Rent	XX		
Stationary & Printing	XX		
Other	XX		
Total Administrative		XX	
Grand Total Expense			XX
Patrons Proceeds			$ XX
Less Deductions:			
Advances		$ XX	
Reserves		XX	
Other		XX	
Total Deductions			XX
Excess Income Over Charges			$ XX
Inventory (Sch. C-2)			XX
Patrons Equity			$ XX

STATISTICAL

Commodity ____________ Quantity ________ Size ___________ Grade ______

Make a schedule C-1 for each pool operated during the period.

Inventory

(1) Commodity	(2) Size and Grades	(3) Quantity	(4) Market Price	(5) Amount	(6) Less ______% Selling Expense	(7) Net
	XX	XX	$ XX	$ XX	%	$ XX

Total (to Schedule C-1) $ XX

(This Schedule illustrates how inventory is computed at selling price.)

Appendix 4 A.

Simplified statement form for cooperatives

BLANK ASSOCIATION

Balance Sheet
December 31, 1941

WHAT WE OWN

Cash on hand, and in the bank, which can be used to pay debts, wages and other expenses	$ 1,800.00	
Cash which we will not use immediately, which is temporarily invested in (name of investment)	None	
Amounts owed to us by our members and others for goods, etc., sold to them on credit	600.00	
Merchandise and materials which we have on hand for sale or for use by our association	6,100.00	
Cost of land we own	1,000.00	
Value of buildings and other land improvements needed to do business	2,000.00	
Value of equipment and tools needed to do business	900.00	
Value of other things we own, not listed above	200.00	
Total Value of what we own		$12,600.00

WHAT WE OWE

Unpaid bills for goods and expenses	$ 200.00	
Employees wages	100.00	
Mortgage loan and interest	7,600.00	
Total of our debts		7,900.00

DIFFERENCE

The value of what we own exceeds our total debts by	$ 4,700.00

Appendix 4 B.

BLANK ASSOCIATION

Operating Statement

For the Period from January 1, 1941 to December 31, 1941

We received income from sales amounting to	$ 9,500.00
Which cost us	6,500.00
Leaving a difference of	$ 3,000.00
We received rental and other income amounting to	2,500.00
Making our total income of	$ 5,500.00
Our total expense of doing business amounted to	1,200.00
This resulted in net earnings for the period in the amount of	$ 4,300.00